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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Accounting problems arising during privatization in Czechoslovakia

Report of the Secretary-General

SUMMARY

Czechoslovakia, like the other countries in Central and Eastern Europe, is making the transition from a planned economy to a market economy. The most important feature of this transition is the desire to achieve a rapid transfer of property from the State sector to the private sector. Small enterprises are being privatized rapidly, actually within one year, and the privatization of medium and large State enterprises is being scheduled for the next five years. The National Property Fund, an independent legal entity, has been created to hold the assets of both the small and large enterprises being privatized. Public auctions, public offerings or the creation of joint stock companies are being used to transfer assets. Because of the lack of capital

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in the private sector, foreign investors are allowed to participate in large privatizations, and a coupon scheme has been developed to allow citizens to invest in former State enterprises. The accounting system used under central planning is being modernized to serve a market economy. Valuations of tangible and intangible assets and liabilities are being undertaken for enterprises selected for privatization, to create an opening balance sheet. A common problem in valuations is the lack of both quality data and historical data for comparative purposes.

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I. FACTORS INFLUENCING THE SELECTION OF PRIVATIZATION METHODS 1/

A. Motivations

1. The Government launched a programme of economic transformation in 1990. The principal steps of the programme are the liberalization of prices and import restrictions, convertibility of the nation's currency, expansion of the private sector, a macroeconomic anti-inflation policy, social security and an environmental protection policy. The main task of macroeconomic regulation in the process of the transition is to prevent economic shocks from causing severe countrywide disturbances, rapid inflation or a disproportionate increase of foreign debt.

2. Change of ownership is considered the crucial issue for Czechoslovak economic reform. A market economy will be created in Czechoslovakia by transferring the means of production from State ownership to private ownership. The share of private ownership in the Czechoslovak economy is expected to grow in two ways:

(a) New private enterprises will enter the economy and expand;

(b) State-owned enterprises will be privatized.

3. The transfer of State enterprises to the private sector will improve their efficiency and competitiveness. The role of enterprises in the former centrally planned economy was to fulfil the requirements of the central plan. Consequently, the enterprises were always modifying the requirements of the plan to their own ends. Now that central planning has been abandoned and prices liberalized, enterprises are virtually independent, and that means they must bear both the positive and the negative consequences of their operations. Many enterprises have extensive inventories of materials and products, and this has caused a shortage of working capital and equity.

4. Central planning restructured the economy by reallocating investment capital. Light machinery and consumer goods industries generated capital which was invested in heavy engineering and metallurgy. The principal objectives were to maximize the quantity and not the quality of production and to attain a high level of exports to other planned economies. The emphasis on heavy industry exhausted natural resources and devastated the environment. Another consequence of State investment policies was a low rate of return on capital, which caused a shortage of capital needed to maintain or replace productive assets which could increase efficiency while protecting the environment.

B. Economic, financial and social conditions

1. Availability of local capital

5. During the past 40 years, there have been no financial markets in Czechoslovakia. Business enterprises turned their excess funds over to the State and received funds according to financial plans. Members of the general public could not invest their savings, and stock exchanges and commercial banks, as understood in the West, did not exist. The domestic market was dominated by the Czechoslovak State Bank and several other banks that operated abroad.

6. In the future, the general public will be able to use two savings banks - the Czech and the Slovak Banks. Last year, two commercial banks separated from the State bank. There are now several new banks with different specializations, and a stock exchange also will be established. There are also new laws on insurance which will enable the start-up of new insurance companies (Act No. 185/1991 of the Czech Republic on Insurance, May 1991, and Act. No. 24/1991 of the Slovak Republic on Insurance, January 1991).

7. State banks and insurance companies will be privatized by public share offerings. A certain number of the shares will, however, remain in State hands.

8. The savings of the general public at this time are not sufficient to enable them to participate in the privatization process and invest in the development of the economy. For that reason, the Government has decided to allow citizens to obtain investment coupons which can be used to purchase shares in enterprises (see sect. II).

9. Further development of the economy will not be possible without foreign capital. At present, there are over 3,700 joint ventures in Czechoslovakia, but only a small fraction are in actual operation. 2/ The amount of foreign capital invested in them from 1987 through 1991 was approximately $500 million, which is low, but the Government expects that the interest of foreign investors will grow, especially due to the availability of skilled labour in Czechoslovakia. The largest industry segment is general manufacturing, and the greatest amount of foreign capital invested in the aforementioned period came from Germany. Foreign capital will be given preference over domestic sources in large privatizations, whereas small privatizations are intended chiefly for domestic investors.

10. In 1991, the State Bank started the so-called secondary share market, a predecessor of a stock exchange, where the obligations of banks and enterprises, which have been issued since 1990 to obtain capital, can be purchased. Also, a 1950 law on bills of exchange and cheques (Act No. 191/1950, December 1950) has come into force again.

11. The functioning of the capital market is restricted, because Czechoslovak currency is currently not convertible, but internal convertibility for registered legal persons was introduced in 1991.

2. Socio-political considerations

12. For the purpose of economic reform, several laws regulating the privatization process have been adopted. A social safety net has been created to mitigate the impact of unemployment and inflation. The net contains unemployment benefits and training programmes financed by the State.

C. Particular circumstances of an enterprise

Size and sector

13. In the small privatization process, State-owned shops, restaurants and other service enterprises and small production units are being sold to private owners at auction. The auctions are conducted by the bodies of the regional or municipal administrations rather than by banks or the financial markets. In some cases the current selling price exceeds by many times (as much as 300 times) the initial sales price. In other cases, the current selling price has dropped to less than 50 per cent of the initial sales price.

14. The privatization of large State enterprises will begin in early 1992. The lists of enterprises to be privatized and of the enterprises that will be excluded from privatization in the next five years has already been completed. In 1990, some of the State-owned enterprises were transformed into State-owned joint-stock companies in accordance with the law on joint-stock companies (Act No. 104, Joint-Stock Companies Act, April 1990). This law has been replaced, effective 1 January 1992, by the new Company Act, No. 513 (November 1991).

15. For the next five years, non-profit enterprises and institutions such as hospitals, schools etc. will be excluded from privatization. Non-profit enterprises and institutions require financial support from the State. They produce revenues, but the prices for their services are too low to cover their costs. The loss is covered by the State budget. They do not pay corporate taxes, and their profits go to the State treasury. The revenues of other social welfare enterprises and institutions belong to the State, and their capital expenditures are financed directly from the State budget. Services are usually free of charge, and the operating costs are covered by State grants. This system is usually used by schools, ministries, courts etc. Most of these institutions will not be privatized.

II. IMPLEMENTING THE PRIVATIZATION PROCESS

A. Large and small privatization

16. The path to reform will have two stages: denationalization, and privatization. The most important rules are given in the transformation law - that is, the law on privatization of large enterprises (Law on the Terms of Transfer of State Property to Other Persons, 26 February 1991).

17. Besides this law, there is also the law on small enterprise privatization (Law on the Transfers of State Property to Other Legal or Natural Persons, 25 October 1990), the law on the ownership of land (Act No. 229/1991 on ownership of land and agricultural property, July 1991), and the law on community ownership (Act No. 172/1991, Czech Council on Transfer of State Property to Municipal Entities, May 1991), the draft government decree regulating the coupon privatization, and draft laws of the national councils regulating the National Property Funds of the Czech Republic and the Slovak Republic.

18. The law on large enterprise privatization referred to above regulates the conditions for the transfer of State property operated by State-owned enterprises, State-owned banks, State-owned insurance companies and others to ownership by Czechoslovak and foreign legal and physical persons. According to the provisions of this law, the property included in the small enterprise privatization and the property subject to restitution will be separated from the large enterprise privatization.

B. Creation of the National Property Funds

19. There will be three National Property Funds in Czechoslovakia - one federal and two belonging to the republics. They will function as independent legal entities. Denationalization in Czechoslovakia occurs by the transfer of an enterprise's assets to the National Property Fund.

20. The capital gained by the State in the process of privatization is deposited in the National Property Fund. This Fund is not part of the national budget and is not to be used for general government expenditures, since privatization is not being undertaken to solve budgetary imbalances. The State does not have the right to manage the capital of the Funds, since the Funds are independent legal entities. This should prevent the growth of the amount of money in circulation and contain inflation. The capital of the National Property Funds is to be used to cover compensation of former owners of nationalized properties. The proceeds from the sale of property in small enterprise privatizations will be under the control of the ministries of national property. A part of the funds will be used to cover the cost of small privatizations, and the rest will be regulated by the laws that the national councils will pass within the next two years.

C. Privatization project plan

21. The transfer of property according to the law on large enterprise privatization referred to above is based on the privatization project plan for the enterprise or on the plan for the disposition of the State's share of ownership interest in the enterprise. The State authority responsible for the enterprise may also be responsible for preparation of the project plan, but the draft can be prepared by the enterprise's management or by another entity.

22. The organization of the privatization programmes, including the methods of defining the property to be privatized, is the responsibility of the Ministry of National Property and Privatization. This agency is also responsible for reviewing and approving the project plans.

23. The privatization project plan consists of:

(a) The exact description of the enterprise and the designation of the property to be privatized;

(b) A description of the way that the State acquired the property;

(c) Identification of property unsuitable for business activities (for example, uncollectible claims, fixed and intangible assets, and inventory items whose book carrying value has been impaired;

(d) The current valuation of property to be privatized;

(e) The programme for the transfer of property and the settlement of restitution claims;

(f) The definition of the legal form of the new company;

(g) If a joint-stock company is to be established, the planned classes and distribution of shares and the programme for the use of investment coupons;

(h) If the enterprise will be sold, the type of sale, price expected and payment conditions;

(i) A listing of intangible assets to be transferred, such as patents, copyright and brand names;

(j) The timetable of the project.

24. A privatization plan can also contain recommendations concerning the line of business; it can identify potential purchasers of the enterprise or its shares, define the market position of the enterprise and describe the qualifications and capabilities of its employees. In this way, the privatization of a part of an enterprise, the whole enterprise, or several enterprises to be combined may be planned.

D. Investment coupon scheme

25. On 5 May 1991, the Government passed a decree regulating the issue and use of coupons. Coupons, sold in coupon books, may be used for payments in the transfer of State-owned property to private ownership. The Government expects that by the end of 1992 there will be two groups of enterprises privatized, each with its own series of coupon books, involving about 2,000 medium-sized State-owned enterprises. The property offered in each group will

be worth at least Kčs 200 billion ($US 7.14 billion). Any citizen of Czechoslovakia over 18 years old with permanent residence in the country can become a coupon holder. The investment coupons will be used to buy shares of former State-owned enterprises that have become new joint-stock companies. The prices of the shares will be expressed in investment points. An investment coupon holder can spend 1,000 points. Coupon privatization is not supposed to add capital to the State but to find real owners - people who will take care of the property - and to distribute State property justly and quickly. Any other method to accomplish the same objectives would take too much time because of the shortage of capital in the country.

26. The coupon privatization programme will be divided into several stages so that groups of companies can be privatized in a certain period of time. In each stage the same process will be followed. First, the initial price of each share, expressed in points, will be announced (the nominal price will be Kčs 1,000) ($36). Each citizen will be able to buy shares worth Kčs 90,000 ($3,200) for his/her 1,000 points. If the demand for shares of a company is less than offered, all the potential buyers will be satisfied. If a large number of shares still remains unsold, they will be offered at lower prices. If the demand is greater than what is offered, the demands of the potential buyers will not be satisfied and the shares will be offered for higher prices. This process could be repeated in several rounds.

27. If there is exceptional demand for certain companies, the companies will be excluded from coupon privatization and sold at auction. The companies that fail to attract buyers will be sold to anyone for a symbolic price under certain conditions - for example, to retain the employees.

28. To make this scheme easy for an average citizen, so-called "investment funds" will be established. The funds will buy shares for the customers who have given their coupons to the fund in trust. The citizens will receive the fund's own shares. A coupon holder will be able to order shares in an investment fund only when the first privatization process begins.

29. Coupon privatization is a very complicated process, and a special company has been authorized to take care of all of the operations. Offices serving the public will be established at the post offices.

III. PRIVATIZATION METHODS USED IN CZECHOSLOVAKIA

30. Private ownership was virtually abolished in Czechoslovakia after the Second World War. Its absence and the resulting problems are considered the main causes of the inefficiency of the economy. The Government feels that rapid privatization of some enterprises is necessary - above all, in the sectors of trade, services, hotels etc.

31. The following specific privatization techniques are to be used in Czechoslovakia:

(a) Restitution to former owners;

(b) Public auctions;

(c) Public competition by public offerings;

(d) Direct sales or leases;

(e) Conversion of enterprises into joint-stock companies;

(f) Sale of State-owned shares in joint-stock companies and joint ventures; and

(g) Free transfer of assets.

32. To satisfy restitution claims, expropriated property may be returned or, in case it has ceased to exist, investment coupons may be given as compensation.

33. Public auction as a standard technique of privatization may be used for both small and large privatizations. The assets sold at public auction could be either entire productive enterprises, with buildings and land, or only the tenancy rights of the premises for two years. The leasehold term may be extended to five years.

34. Public competition starts by making domestic and foreign offerings. Bidders will compete on the basis of the sales price, investments to improve the enterprise's efficiency, the plan for employees' wages, efforts to minimize unemployment, the quality of the business plan, planned investments for improving the environment and the programme of contributions to general community activities.

35. Privatization in economic sectors such as trade, services, hotels etc. (small privatization) is being accomplished by direct sale of enterprises at auction or by leasing such businesses to entrepreneurs. Privatization by direct sale to a designated purchaser may be used in some restitution cases when the privatized property complements the property already returned to the owner. The authorized person will have priority over other buyers. A privatized unit can also be sold directly to a new company organized by its employees.

36. Enterprises can be converted into joint-stock companies with the National Property Fund as the main shareholder. The next step will be the transfer of 3 per cent of the shares to the Restitution Fund, the sale of shares for investment coupons, the direct sale of shares to employees and possibly, the sale of shares on the stock exchange. This is expected to be the most common method of privatization.

37. Where the State owns shares in existing joint-stock companies or joint ventures, such shares will be transferred to the National Property Fund and then sold for coupons or directly to investors through a stock exchange.

38. Free transfer of property is possible in exceptional cases when other attempts at a sale fail to attract purchasers. In such cases, a privatization project plan must still be drawn up. Further transfers will be forbidden for a certain period of time.

39. As of 31 December 1991, approximately 10 large and 6,000 small enterprises had been privatized. The pace of large privatizations is expected to increase significantly in 1992.

IV. IMPLICATIONS OF PRIVATIZATION FOR ACCOUNTING

A. Use of commercial accounting systems by state-owned enterprises

40. The Czechoslovak accounting system is regulated by government decree No. 236/89 and the decree of the Federal Ministry of Finance No. 23/90. Individual types of enterprises and companies have their own obligatory charts of accounts and instructions. State-owned enterprises, joint-stock companies and joint ventures use an identical financial accounting system with double-entry bookkeeping based on generally accepted concepts such as the business entity as a reporting unit, money measurement for transactions, use of historical cost, a going-concern assumption and accrual accounting. Use of management accounting concepts are regulated only in relation to mandatory financial accounting requirements.

41. However, the purpose of accounting in the centrally planned economy was to provide information on the implementation of the central plan, on the amounts and the flow of production costs and on current results of operations. Such an approach to accounting was very different from that in a market economy. Privatization, as one of the major steps towards a market economy, has provoked a number of questions concerning the traditional approach to accounting.

42. The present accounting system does not distinguish between information needed for an impartial evaluation of the enterprise and for information required by government regulators. The fact that the State supports some types of enterprises by subsidies, by, for example, allowing rapid depreciation of assets, is recorded as if the physical depreciation of the property was really faster. The interface between the financial accounting methods and the methods to be used for fiscal and tax reporting purposes is an extremely important issue, because the reform of the tax system is closely connected with the reform of the accounting system. The taxation policy makers and collection authorities must be able to obtain appropriate financial data for assessing proper taxes to finance the Government.

43. According to current accounting methodology, small State-owned enterprises (up to 100 employees) can use single-entry bookkeeping, recording revenues and costs without applying accrual concepts. Private entrepreneurs with less than 25 employees and a maximum profit of Kčs 540,000 ($19,300) a

year can use single-entry bookkeeping in a day book. Business companies can use double-entry accounting in a simplified version designed for private entrepreneurs, which is based on principles similar to those used by State-owned enterprises but is less complicated.

44. The current Czechoslovak system of accounting will still be obligatory for the enterprises privatized in 1992. Part of the new plan on accounting will come into force in January 1992. Other provisions concerning the overall preparation for economic reform, however, will not come into force until 1993 when the chart of accounts and accounting principles will be changed. A question about whether to use continental European or Anglo-Saxon accounting methods was finally resolved, and it was decided that the continental system would be adopted because of historical business traditions. The accounting system will be uniform but will provide a great deal of flexibility. Because the changes will be extensive, detailed instructions and cross-references will have to be prepared in accordance with international accounting standards, to provide adequate information for the privatized entities.

45. It is expected that smaller State-owned enterprises will run into difficulties when changing from single-entry to double-entry bookkeeping methods. Also, because a privatized unit may actually consist only of a section of a larger enterprise or of parts of several enterprises, it will be necessary to compile useful information for the new entity. For example, if only a part of a company's assets is included in privatization, it will be necessary to define the liabilities associated with those assets which are to be transferred to the new entity's accounting records. Because of the need to have comparative information for more than one accounting period when negotiating with foreign partners, many enterprises are trying to find ways to record comparable information for current reporting purposes. A number of valuation problems are discussed in a subsequent section.

B. The reporting process

46. Each of the privatization methods mentioned above has its own designated procedures to be followed and set of forms with the data needed for the authorization and completion of the privatization project plan. The forms differ in some particular aspects but generally contain the following data:

(a) Name of the enterprise, headquarters location, and number of branches and where they are located;

(b) Characteristics of the business such as its line of business, position in the market etc.;

(c) Economic characteristics for the most recent three-year period:

(i) Total number of employees and number of production workers;

(ii) Average cost of wages per month;

(iii) Revenues;

(iv) Expenses;

(v) Net profit;

(vi) Export sales;

(vii) Subsidies;

(viii) Total depreciation expense for fixed assets.

A balance sheet of an independent unit to be privatized must be prepared before the privatization project plan is presented. Land is valued according to a decree of the Ministry of Finance of the Czech Republic, if it has not been recorded previously in the books at the date of the balance sheet. Other assets that were not recorded in prior years - for example, the cost of modernization and reconstruction of fixed assets which was not included in their historical cost - must also be recorded in the balance sheet;

(d) The expected profit from the sale of assets unsuitable for planned business activities;

(e) The expected profit from the sale of inventories to be included in property sold at public auction;

(f) The total assets of the unit to be privatized;

(g) Intangible assets not recorded in the accounting records, with specifications as to the nature and valuation of each item;

(h) The rights and duties of the enterprise arising from contracts:

(i) Business contracts - firm contracts with suppliers and customers, including State orders, quantities, prices, term for fulfilment of commitments etc.;

(ii) The expenses connected with legal liability for defective products in the past three years;

(iii) Assets subject to restrictions on the transfer of real estate: description; value of the mortgaged assets; term of restrictions; and portion of the mortgaged assets that has not yet been paid;

(iv) Contracts for operating leases entered into by the enterprise as lessor: description of the item leased; name and address of the lessee; term of the lease; and yearly rent;

(v) Contracts for operating leases entered into by the enterprise as lessee: description of the item leased; name and address of the lessor; term of the lease; and yearly rent;

(vi) Contracts for operating leases after the transfer of property rights: description of the item leased; name and address of the lessee; net book value of the leased property; the expected date of the last instalment payment; and, the amount that has not yet been paid;

(vii) The contracts for financial leasing after the transfer of property rights (passive leasing): description of item leased; name and address of the lessor; net book value of the property; the expected date of the last instalment payment; and the amount that has not yet been paid;

(viii) Other rights and duties - descriptions, characteristics, and expected effect on finances (for example, compensation indemnity or rights and obligations, resulting from unconcluded court or arbitration proceedings etc.);

(i) Statement as to whether or not the State-owned assets are subject to restitution claims. In the case of restitution claims, the assets involved and the amounts of such claims must be defined;

(j) The planned equity of the proposed joint-stock company;

(k) The planned types and estimated amounts of reserves of the new company;

(l) The share of the planned equity which will come from sources other than State-owned sources;

(m) The characteristics and valuation of the contributed assets from sources other than State-owned sources:

(i) Description of the source;

(ii) Name and address of the contributor;

(iii) Valuation of the contribution;

(iv) Valuation technique used;

(v) Special conditions;

(n) Justification for the particular privatization method to be used;

(o) The business plan:

(i) Analysis of production and marketing capabilities;

(ii) Quantification of the investments needed and the probability of acquiring such capital;

(iii) Analysis of labour requirements; for example, necessary changes in employment status and in the qualification profile of employees, the cost of requalification and the cost of compensation;

(iv) Planned future profit and its distribution;

(v) Other data concerning the company (problems of ecology, the plans to raise capital by debt etc.);

(p) Plans for the founding of the joint-stock company:

(i) Description and location of the principal office;

(ii) Timetable for the founding process;

(iii) Company shares - type, number, nominal face amount per share;

(q) Quantity of the shares that will belong to the National Property Fund after the joint-stock company is established:

(i) Free transfer of shares to communities, social security funds, banks and savings banks: number of shares; part of the company's total basic capital they represent; type of shares; nominal face amount per share; future shareholders, if different; justification for the free transfer; and term of the transfer;

(ii) Privatization by the investment coupon method: number of shares; and, part of the company's total basic capital they represent;

(iii) Shares left in the National Property Fund: number of shares; part of the company's total basic capital they represent; type of shares; nominal face amount per shares;

(iv) Direct sale of shares: number of shares; part of the company's total basic capital they represent; type of shares; nominal face amount of the shares; future shareholders, if different; reasons for the sale to the subject; purchase price; method of determining the purchase price;

(v) Sale through a bank or the stock exchange: number of shares; part of the company's total basic capital they represent; type of shares; nominal face amount per share; method of determining the purchase price; designation and location of the broker;

(r) Appendices - drafts of documents needed for establishing the company.

C. Valuation of enterprises

47. A privatization project consists of the following required steps: identification of the assets or State-owned shares to be privatized; designation of which claims are eligible for restitution; and identification of the assets unsuitable for the future activities of the business which will be disposed of before the privatization and of the assets that will be sold at public auction or by other means.

48. A company's assets are usually valued according to historical cost if the business is being sold to citizens of the country and there will not be any foreign investment. Buildings, machinery and equipment are depreciated, and their book values correspond to their historical cost less accumulated depreciation. Valuation of the total enterprise is based on the net book value - i. e., total assets minus total liabilities in the cases where only domestic capital is being raised. If foreign capital is being raised, the valuation must be according to generally accepted methods of valuation. A fair market valuation is obtained, which attempts to approximate fair market prices in other countries. The valuation must be authorized by the Ministry of Finance, and frequently, the help of foreign consulting firms is requested. Experience to date has shown that it is not possible to guarantee the fair and objective valuation of property, even when very exacting methods are used. Also, the exchange rate of the Czechoslovak crown has to be taken into account. At present, the exchange rate favours foreign investors.

49. When determining the net book value of the enterprise, several important facts must be considered. Because enterprises did not keep records on land and intangible assets and costs of reconstruction and modernization were not included in the actual cost of fixed assets, those data must now be taken into account in the process of business valuation, if not already included in the books of the privatized enterprise.

50. The valuation of buildings is based on their historical cost less accumulated depreciation. Because in the socialist system the rates of depreciation were typically very low - 1 or 1.5 per cent a year - the net book values may be overvalued. However, a number of buildings have been reconstructed, and the cost of reconstruction was not added to the historical cost of the assets. In such cases, the net book values are low and do not correspond to fair market values.

51. The valuation of machinery is also based on the net book value, as stated above, adjusted for the low rates of depreciation used in the past years.

52. Stocks (inventories) are recorded using one of the following methods: average cost, first in/first out or last in/first out. A source of distorted information in balance sheets is the book value of inventories. The fair economic value of the inventories is often lower than their book values. The valuation of inventories unsuitable for use (for example, excess spare parts or materials and products that are unusable) may also present some problems for a restructured enterprise.

53. Beginning in 1991, intangible assets are also being recorded. Special methods for valuing some types of intangibles have been developed, but experience in this area is lacking.

54. The Government has not yet determined a method for assigning debts of enterprises to newly privatized companies. Valuation of receivables, particularly from foreign countries, is very difficult. Liabilities may be allocated according to the amount of assets that remain with the enterprise in proportion to its former total assets. Credits for construction of assets and for the purchase of inventories may be allocated according to the number of employees, revenues etc.

55. At present, there are many insolvency cases in Czechoslovakia and a number of enterprises have high amounts of receivables and high debts. The Government is trying to solve the question of eliminating debts, but a method for the valuation of receivables will probably not be specifically defined. The receivables that have resulted from sales of materials and supplies to other enterprises in excess of their needs may be difficult to value and ultimately to collect.

D. The new accounting law

56. Czechoslovakia's draft accounting law, 3/ which became effective 1 January 1992, applies to all accounting entities. Certain sections concerning valuations and depreciation will not be in effect until 1993. In attempting to move away from the old system by simplifying the new one, the drafters have restricted the contents of the new law largely to record-keeping rules, with little in the way of accounting principles. A chart of accounts is to be established for all public and private entities in the productive sectors; a special one is to be created for non-profit organizations. Historical cost is generally required, with some exceptions, and although a balance sheet and a profit-and-loss sheet are identified as the required annual accounts, no formats are described. The enclosures to both these statements are to contain information concerning valuation methods, write-off methods, accounting methods, and method of evidence used in the reporting period. The objective is to help the user assess the situation with respect to sources of assets, the financial situation, and result of the accounting unit's economies. An extraordinary annual report is also to be issued which covers the period ending on the day of liquidation or competitive tender.

57. The draft law mentions the need for certain disclosures required by a number of international accounting standards, such as statements of accounting policies, post-balance sheet events, related-party transactions, conflicts of interests, property disputes or potential claims and provisions for third-party claims to assets, pensions, and environmental damage, as appropriate.

58. Joint-stock companies must have their annual and extraordinary accounts audited and published in an annual report. Other accounting entities must

also publish their accounts, which need not be audited unless, during the preceding fiscal year, net annual turnover exceeded 40 million crowns or the amount of net commercial property exceeded 20 million crowns. The annual report is deposited at the Registration Court and must be made available for public inspection for the subsequent 10-year period. The annual report has to be audited and should include details from the annual accounts, the auditor's statement, important facts relating to the annual accounts, and verifiable explanations about the prior and prospective development of the entity's activities and its financial situation. The new law stresses the importance of prospectuses presented to companies, shareholders, banks and others.

59. In general, balance-sheet items are to be valued at cost unless adjusted by a fair market valuation, as discussed below, or the lower of cost or net realizable value, in the case of inventories, and provisions should be made for risks and losses. Accounting entities are, for the most part, free to set their own depreciation and amortization policies, assuming normal use.

60. When an enterprise has been privatized, a beginning balance sheet must be prepared. When foreign investment has been obtained, as mentioned above, a fair market valuation of the enterprise is prepared. If the net asset valuation is greater than the historical book value, a new account - called "the rectifying item referring to property" - which is comparable to a goodwill account, is introduced into the chart of accounts. The amount in the account can be amortized into the periodic profit and loss from operations but not directly against equity, over a period of seven years. The goodwill account represents the difference between the market valuation of the enterprise and the total valuation of all of the enterprise's net assets, using depreciated replacement costs as the basis for making the valuations.

61. In the small privatizations that have occurred to date, the selling price has often exceeded by many times the beginning equity (net assets) of the enterprise. The comparatively large difference was allocated to individual property accounts, and the balance was recorded as organization expenses. These expenses can be amortized against the profit from operations at the rate of 15 per cent each year. Most of the enterprises sold at auction to date did not continue their former lines of business. Their owners established completely new businesses. Thus, the recording of goodwill was not appropriate.

62. When large privatizations start in 1992, the beginning balance sheets of the enterprises privatized by the coupon method will be very important. Valuations will be based on book values, and the prices for the enterprises will be based on the total number of coupons that the public will be willing to invest in the enterprises. The most important task will be determining the amount of the equity and general reserves for each enterprise. For enterprises with substantial unnecessary property which cannot be sold profitably, this process will be even more complicated.

63. So far, there have not been, and probably will not be, any changes in the system of accounting for changing levels of prices (inflation). Due to price

liberalization, the rules for revaluation of inventories were introduced this year. In case of significant inflation, indices for the valuation changes are to be used.

64. It will be necessary to train accounting personnel in the market economy system of operations before the new system of accounting comes into force in 1993. France, Germany and the United Kingdom have already been involved in training projects in Czechoslovakia.

E. The new auditing law

65. The auditing profession was reinstated in Czechoslovakia when the first joint ventures were established in 1989. The new law on auditors, prepared in accordance with the Eighth Directive of the European Community, will establish auditors as members of an independent profession with their own self-regulatory professional bodies - the Chamber of Auditors of the Czech Republic and the Chamber of Auditors of the Slovak Republic. The education, training and professional examinations of auditors will be subject to new regulations. The only decisive authorities in the matters of auditing will be the two chambers. It is expected that auditors may be allowed to form corporations in order to conduct their practice. The period of transition in this field will probably be lengthy. It is expected that the present system of training and examination of auditors will last until 1995, and then requalification and re-examination will have to be provided. At present, there are only 500 auditors in Czechoslovakia, and that number will probably have to be increased to 3,000, with continuing improvements made in their professional skills and knowledge.

Notes

1/ This case study is based on a written contribution from the Ministry of Finance of the Czech Republic.

2/ Economic Commission for Europe database, end of second quarter, 1991.

3/ Draft Law of Accounting, latest version as of September 1991, furnished by Ministry of Finance.